3

NOTES ON CAPITAL CREDITS

A Comparison

A. The main difference between REA co-ops and other types of co-ops is found in the financial structure and the way in which patrons' overpayments are handled.

1. The typical marketing co-op requires a relatively small capital investment in proportion to its annual business.

   a. The members put up a substantial part of the capital needed when they start the business. This means, in turn, that such a co-op needs to borrow relatively little money from outsiders and therefore has no heavy loan repayments to meet.

   b. If it finds at the end of the year that its charges for services to its patrons have been in excess of the cost of service, it can return most of that difference to them as patronage refunds, either immediately or at least within a few years.

2. An electric co-op, on the other hand, requires a relatively high capital investment per member. The annual business turnover amounts to only a fraction of the cost of its facilities.

   a. REA co-ops are financed one hundred percent with an REA loan. In other words, the members have made no initial capital investment in their REA co-op aside from the small membership fee.

   b. It follows that amounts paid in by members above the cost of services are needed to pay back the Government loan. Since the money representing overpayments for service is applied toward reducing the indebtedness to the Government and cannot at the same time be repaid to the consumers as cash patronage refunds, a system of capital credits has been developed.

Capital Credits -- What Are They?

A. The idea.

1. Rural electric co-ops are based on the proposition that the people who use the service are also its owners.

2. Under the REA loan program the co-op members are not required to put up initial capital. But the loan capital borrowed from the Government must be paid back. To do this the co-op collects from its patrons not only the money needed to pay the actual costs of service, but also amounts which can be used toward repayment of the REA loan. These extra amounts are in effect capital furnished by the patrons.

Instead of making a substantial original investment, each member builds up his individual share in the ownership of the co-op on the installment plan. Obviously, each member should receive full credit for the capital which he supplies.

3. In simplest terms, then, capital credits is a plan for recognizing and accounting for each member's individual capital equity in his co-op.

B. Definition.

Capital credits is based on a legal agreement set forth in the co-op by-laws, that amounts paid by the patron to his co-op in excess of the cost of service will:

1. Be credited to his account as patronage capital furnished by him;

2. Be repaid on a revolving plan, when the financial condition of the co-op justifies it.

C. How the plan works.

The two factors which determine whether there are any capital credits to be assigned and what amounts are available for such assignment are, first, the gross operating revenue which is what the members have paid for service, and second, the cost of that service. If the cost is less than what the members paid, then there is a net margin which belongs to the members and is to be credited to them as patronage capital. This is done on an annual basis.

1. The first figure -- gross operating revenue -- is made up of the total of the members' billings for the year.

2. The second figure -- cost of service -- is made up of all of the items which any utility business includes in figuring its cost of service. In includes, for example, an allowance for depreciation and interest on the REA loan. But it does not include any repayments made on the principal of the REA loan because the payment of a debt is not considered a business expense either legally or from an accounting standpoint.

3. At the end of the year, co-op management subtracts cost of service (item 2 above) from gross operating revenue (item 1 above). The remainder is the net margin which is to be assigned to them as capital credits.

4. To determine each individual's credit, the net margin is calculated as a percentage of the total receipts in payment for electric service. This percentage is then applied to each patron's bills during the year.

Example: If the co-op took in $100,000 and cost of service was $90,000, the overpayment (net margin) was $10,000. This would be a 10 percent patronage credit. Applied to each

individual patron's bills for the year, someone who had paid $100 for his electricity would have $10 to his credit, while someone who had paid $65 would have $6.50.

5. In other types of co-ops this amount would be called a patronage refund and would be returned to the member or patron in cash or be held for a short period as revolving capital, in accordance with the wishes of the membership as expressed in the bylaws.

6. However, since the REA co-op is obliged to repay to the Government the initial capital which it borrowed, it can't pay these amounts back to the members (and any other patrons) in cash immediately.

7. The co-op therefore obligates itself to account for the individual's overpayment as capital credits. Of course, the co-op can use the money representing patronage capital -- for example, to pay off some of the loan capital borrowed from REA.

8. Capital credits accumulate in the individual capital credits accounts of the members in varying amounts depending upon how much the member paid for the electricity he used during the year, and depending upon how much of a net margin the co-op showed after taking care of all expenses for the year.

9. In any year in which the co-op had no net margin, it is obvious that there would be no capital credits to add to members' equity.

D. Revolving patronage capital.

1. When the financial condition of the co-op makes it feasible, the co-op may begin retiring some of its capital credits. Bylaws of most REA co-ops provide that no retirement may be made that will reduce the capital below 40 percent of the co-op's assets.

2. Any such retirements of capital shall be made in the order in which the capital was furnished and credited. In other words, the patronage capital first received by the co-op will be the first to be paid back.

3. This results in a continuous process of revolving the capital in the co-op.

   a. Even before the REA loan is fully repaid, cash funds may be used -- providing the co-op is in sufficiently sound financial shape -- to retire the earliest capital furnished by the older members.

   b. As current members continue to supply new patronage capital, the earlier credits are paid back to the members in cash. The process is somewhat like water used to turn the wheel of a mill, new water being constantly taken from the stream to keep the mill going and being constantly returned to the stream.

Advantages of Capital Credits

A. What do they mean to members?

1. Adoption and use of the capital credits plan assures service at cost, since the bylaws will then specifically provide for crediting to members' patronage capital accounts any amounts received from them by the co-op in excess of operating expenses.

2. By doing this, the plan maintains and reflects accurately the non-profit status of the co-op.

3. Through capital credits members build up their individual share of equity in the co-op. This is done by using the small overpayments from members as capital rather than by immediately returning these amounts as cash patronage returns. Thus members are able to buy their electric distribution system on the installment plan.

4. Capital credits will be paid back eventually in cash. The provisions of the bylaws, board policies, and the financial status of the co-op determine when capital credits will be paid back to the patrons.

B. What do they mean to management?

1. Capital credits enables the business to be operated for the member-owners without the necessity of raising large sums of initial capital from them.

2. The use of the capital credits plan gives management the periodic opportunity for reminding members of their ownership share in the system and of the need for their continued interest, participation and responsibility for economical operations.

3. The annual notification of capital credits entered on members' patronage capital accounts shows the member what part of his bill is payment for his electric service and what amount is capital. The actual cost of service is then seen to be lower than it had seemed.

4. Cooperation by members in keeping down operating costs, because the capital credits plan assures members of all benefits from such savings.

5. Protection of co-op property by members when they have tangible evidence of their individual share in ownership.

6. Understanding of members in times of emergency and loyal cooperation with management by members who understand the value of their ownership interest in the co-op.

7. Strengthens the co-op's financial position.

C. What do they mean to the non-member community?

1. The non-member public has not been told much about co-ops and therefore lacks correct understanding of either patronage refunds or capital credits.

2. The significance of capital credits in community relations is that it builds up private local ownership, thereby enriching the community as well as the rural people who trade with "Main Street," instead of draining wealth out of the community into distant financial centers.